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**International
Accounting Standards
Board**

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: 20 July 2006, London

Project: Short-term Convergence: Interests in Joint Ventures

**Subject: Direct and Indirect interest in a joint arrangement
(Agenda Paper 12)**

Introduction

1. In December 2005, the Board decided to remove the option in IAS 31 *Interests in Joint Ventures* that allowed interests in jointly controlled entities to be proportionately consolidated. By removing this option, an investment in a joint venture 'entity' would need to be accounted for using the equity method. However, to implement that decision, the Board requested that the staff should clarify the definition of a joint venture and the difference between an interest in a joint venture entity and a direct interest in assets or liabilities of a joint arrangement.
2. The Board was concerned that the definition of a joint venture in IAS 31 might cause a venturer to account for its interest using the equity method when, in fact, the venturer has an economic interest in one or more single assets or liabilities of the joint venture. The cause of this concern is the focus in IAS 31 on the form that a joint venture takes. In particular, IAS 31.24 refers to joint ventures

that are established in the form of a partnership. In many jurisdictions arrangements might be deemed to be partnerships, and therefore jointly controlled entities, even though the intention and the economic substance of the arrangement is that each venturer retains an interest in one or more assets and, or, liabilities of the venture. The Board believes that application of the equity method to the whole arrangement in these circumstances might not result in the investor reporting the assets it controls and liabilities for which it is responsible.

3. The next milestone is clarifying how to identify whether a participant has either an interest in the ‘net’ result or output of a group of assets and liabilities of a joint venture or a direct interest in one or more single assets or liabilities in the arrangement.
4. The issue is identifying the nature of the different interests that participants (‘venturers’) have in a joint arrangement. IAS 31 identifies three types of joint arrangements—jointly controlled operations, jointly controlled assets or jointly controlled entities. The staff intends to use these classifications but will characterise the interests in assets and liabilities as being either direct interests in single assets or liabilities or indirect interests (interests in the outcome of ‘a group’ of assets and liabilities). The proposals will also make it clear that direct and indirect interests can coexist simultaneously (see Appendix C).

Staff recommendations and questions to the Board

5. The staff proposes that interests participants have in a joint arrangement be classified as either direct interests or indirect interests in the underlying assets and liabilities (see paragraphs 18 and 19). Does the Board agree with such classification and how each is proposed to be characterised by the staff?
6. The staff recommends that more research and discussions with preparers, users and other interested parties should be done so that the Board can make a more informed assessment about the likely impact of the proposed amendments in current practice. Does the Board agree?
7. Because the objective of the project is to converge the accounting for joint ventures under IFRSs with US GAAP, a more rigorous assessment of the likely impact on convergence is also recommended. To assist with this the FASB

should be engaged in the process in an early stage (see paragraphs 60-62). Does the Board agree?

8. The staff thinks that the notion of a ‘business’ is helpful in identifying the nature of the interest a venturer has in a joint arrangement:

- An indirect interest in a joint arrangement assumes there is an interest in a jointly controlled business.
- An interest in a business is likely to be an interest in the net activities of the arrangement rather than a direct interest in the underlying single assets and liabilities of the arrangement.
- If a joint arrangement is not a business participants only have direct interests.

(see paragraph 54 and Appendix A).

Does the Board agree?

9. The staff discusses the interaction between the legal structure and economic substance. Does the Board agree that in circumstances as described in paragraphs 42-44 indirect interests in mere contractual arrangement (ie. not an incorporated entity or partnership) should be accounted for by the equity method?
10. In Appendix B the staff provides several scenarios and a preliminary analysis of them. Does the Board agree with the analysis?
11. The staff does not believe that any additional disclosures are required (see par. 59). Does the Board agree?
12. At the March meeting there was some discussion about the impact of whether the outcome of the arrangement’s operation is distributed in kind and the product is a commodity traded on an active market. In the staff view whether the output is traded on an active market is not relevant for the nature of the interests participants may have in the arrangement. If the elements defining an indirect interest are met it does not matter whether the output is tradable or not on an active market (see par. 56). Does the Board agree?

Types of interests in a joint arrangement

13. IAS 31 identifies three broad types of joint arrangements: jointly controlled operations, jointly controlled assets and jointly controlled entities. The Standard does not address the possibility that, under one arrangement, might coexist hybrid structures giving rise simultaneously to direct interests-unilateral or shared-and indirect interests in the underlying group of assets and liabilities.
14. At its March 2006 meeting the Board decided that the driver for accounting by participants in joint arrangements should be the contractual rights and obligations that are created by the joint arrangement, rather than whether the arrangement is of a particular type or form. Participants should account separately for contractual rights to share in the net results or output of the arrangement's operations and any right (such as a right of use) they hold in underlying individual assets or any obligation they incur in respect of underlying liabilities.
15. A joint venture is defined in paragraph 3 of IAS 31 as 'a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control'. This is our starting point.
16. A participant must account for all of its assets and obligations in its balance sheet. For that purpose a participant should look at the explicit and implicit contractual provisions in order to identify which assets and liabilities arise from the arrangement, and whether they represent either direct, unilateral or shared, interests in individual assets or liabilities of the arrangement (a direct interest) or a shared interest in the net output or outcome of the arrangement's operations intended to be carried on by a group of underlying assets and liabilities (an indirect interest). The Standard will need to provide venturers with clear principles and guidance that will enable them to identify whether they hold a direct interest or an indirect interest in the underlying assets and liabilities of the joint venture.
17. Participants in a joint arrangement might have direct access to an individual resource, or a share of it, within the group of underlying assets and liabilities with an ability to generate directly future benefits to these participants. Participants might also be directly liable for one or more liabilities within the

group of underlying assets and liabilities. As a first step, participants should recognise directly all those rights and obligations in their financial statements irrespective of whether an indirect interest also exists. Participants might also have an indirect access to the economic benefits expected to be generated by the economic activities intended to be carried on by the remaining sub-group of assets and liabilities within the arrangement, that are under joint control, ie whereby individual participants do not have either rights to or control over those underlying individual assets and liabilities.

18. We classify the type of interests a participant may have in the group of assets and liabilities of a joint arrangement as follows:

- (a) Direct interests whereby the participant has rights to individual assets and direct obligations to individual liabilities, or to a share of individual assets or liabilities, within the group.¹
- (b) Indirect interests. An indirect interest is a right to a share of the outcome of a group of assets and liabilities under joint control in terms of sharing in the **net** result or output.² In an indirect interest in a joint arrangement, the set of assets is under the joint control of all the participants in the arrangement. Therefore, an individual participant does not have a right or direct access to the economic benefits generated by individual assets within the group but only a right to a share of the common output

¹ In Agenda Paper 9A *Conceptual Framework. Elements 3: Asset Definition II*, paragraph 16, presented to the Board in February 2006 is said “Shared rights or shared access would also give rise to an asset.” In paragraph 24 of said agenda paper is also said that shared as well as unilateral abilities may create an asset. However, the expression ‘shared rights’ is unclear. A participant can only recognise rights it holds. What is shared is the underlying ‘resource’ of which economic benefits are unbundled between several parties. However, each co-tenant has a single and unilateral right to some of those unbundled particular benefits from the resource. How the benefits are unbundled when it is under joint control is governed by the joint arrangement, which determines the nature, content and extension of each participant’s rights. However, once the unbundling criteria have been agreed each co-tenant has a direct ‘unilateral’ right to its share of unbundled benefits. The participant does not control the shared resource as a whole but it controls its right to the part of unbundled benefits that were attributed to it. In the end it is a question of defining the boundaries of the resource. For a participant in a ‘shared’ resource, its resource under control is the share or portion of the resource that was attributed to it by the arrangement.

² We are only considering indirect and ‘shared’ interests (under joint control). If a participant has an indirect interest in the outcome of a group of underlying assets and liabilities to the arrangement that are under unilateral control of that participant, they would be consolidated. If all of the individual assets of the group are under unilateral control of one participant, although the economic benefits are generated from combining such set of assets in producing a determined outcome, the set of assets would be consolidated by the controlling participant, including the outcome generated and any existing minority interest.

expected to be produced by the economic activities intended to be carried out by the set of assets itself.

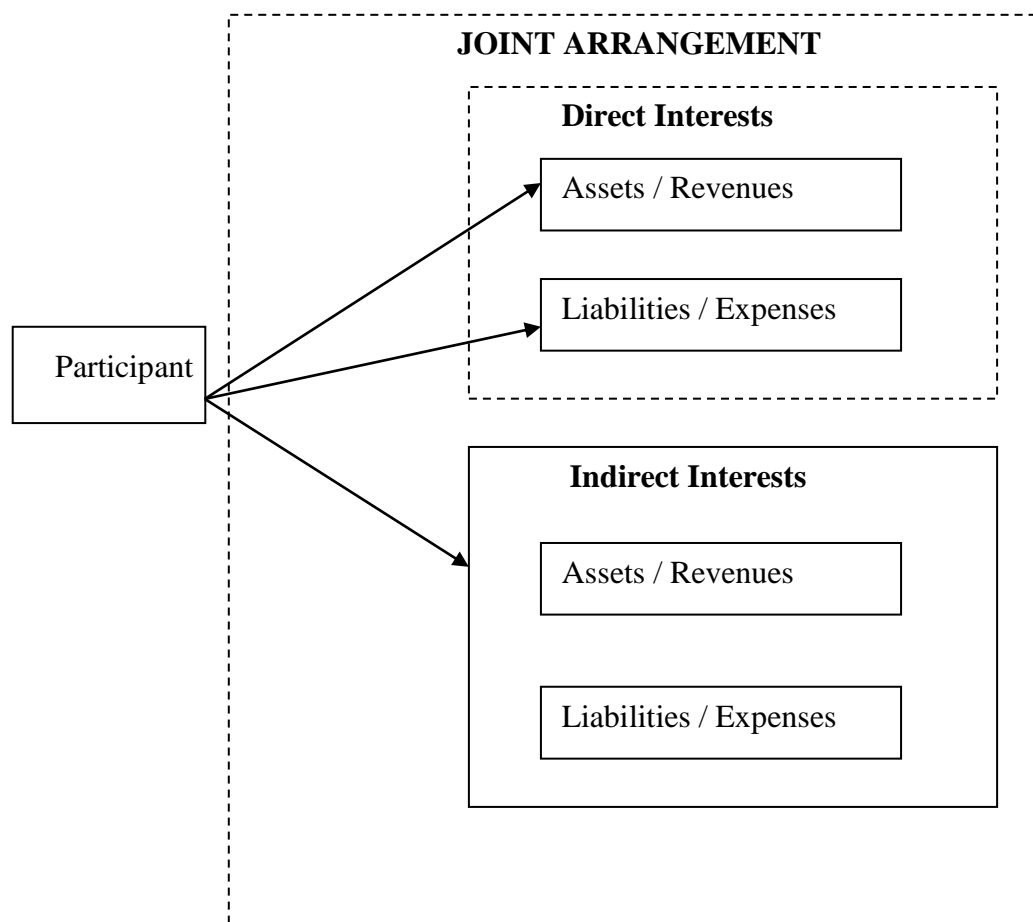
19. The distinction between direct and indirect interests in a joint arrangement might, thus, be characterised as follows:

- (a) A direct interest of a participant is an interest in a single resource, or in a share of it, which the participant controls and is entitled to. The participant has a 'direct' right to such individual resource, or its share of it, that is capable of generating economic benefits directly to that participant, singly or in combination with other entity's assets under its control. The right of the participant is to a single resource or its share of it and the expected economics benefits will come directly from that resource, singly or in combination with participant's other rights under its control. In the latter case, the participant has a right to each single resource used in that combination. That is the main difference with an indirect interest whereby a participant has only a right to share in the net outcome intended to be produced by a group or combination of assets in which the participant does not have rights to or control over those individual resources in the group.
- (b) An indirect interest of a participant in a joint arrangement is an interest in the economic benefits expected to be generated by a group of underlying assets and liabilities intended to carry on an economic activity which the participant does not control and is not entitled to. The participant does not have rights to such individual resources but only a right to sharing in the 'net' economic benefits that are expected to be generated by the economic activities intended to be carried on by that group of resources.³

³ In a group of resources that generate economic benefits to a participant on a combined basis only, we envisage two different scenarios. In one the participant has direct rights to, and control over, all of the individual resources within the group. In that case the participant would directly recognise such assets and liabilities. A second case is when participants do not have rights to individual resources but to sharing in the outcome produced by that group of resources as a whole. This defines an indirect shared interest in the group. An indirect interest only exists when participants do not have direct rights to individual resources, which are under joint control, but they only have a right to sharing in the economic benefits generated from such a combination's operations.

Does the Board agree with such classification and how each is proposed to be characterised by the staff?

20. Direct and indirect interests in a joint arrangement can be represented by the following diagram:



21. Three examples follow, each demonstrating the different rights and interests an investor might have in an undertaking.
22. In the first example, a participant has direct and unilateral access to an underlying individual resource of the arrangement, such as a right of use which is not subject to the consent of any of the other participants.⁴ Such rights should be recognised directly by that participant in its financial statements. This might

⁴ What an individual resource or asset is depends on the unit of account notion. There is no need to establish specific guidance but generally apply applicable standards and entity's policies developed by the entity based on the hierarchy set out in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

happen even if the right takes the legal form of a tenancy in common.⁵ Suppose a company that owns parking spaces allows a significant discount if more than 150 park-spaces are leased on an annual term basis. Three companies set up a joint contractual venture to arrange the contract of 150 park-spaces. Each company can park up to 50 cars at the same time within the area of 150 park-spaces available to the arrangement. There is no specific attribution of space to each participant. Although this co-tenancy meets the definition of an undivided leased interest, each participant (co-lessee) has a unilateral and unconditional access to use 50 park-spaces, whatever they are.

23. Each participant has a direct right in the park-spaces that should be recognised by each participant. This example illustrates how ‘shared’ interests in single resources may be ‘divided’ and an interest can be attributed directly to each co-holder.
24. A second possibility is when participants have a direct right or privileged access to a shared individual resource that is under joint control. However, as direct rights, economic benefits come directly from its share in such individual resource to which a participant is entitled, singly or in combination with other participant’s assets under its control. It is relevant to note that arrangements for joint assets generally place restrictions on each investor. These restrictions generally entail some limitations to the access to the economic resources, since the right of each participant is subject to some extent to the rights of the others. For example, if a participant’s asset consists of a right to use, the arrangement might limit the way, and the period over which, the asset can be used. It might also include restrictions on such things as maintenance and repair programming.

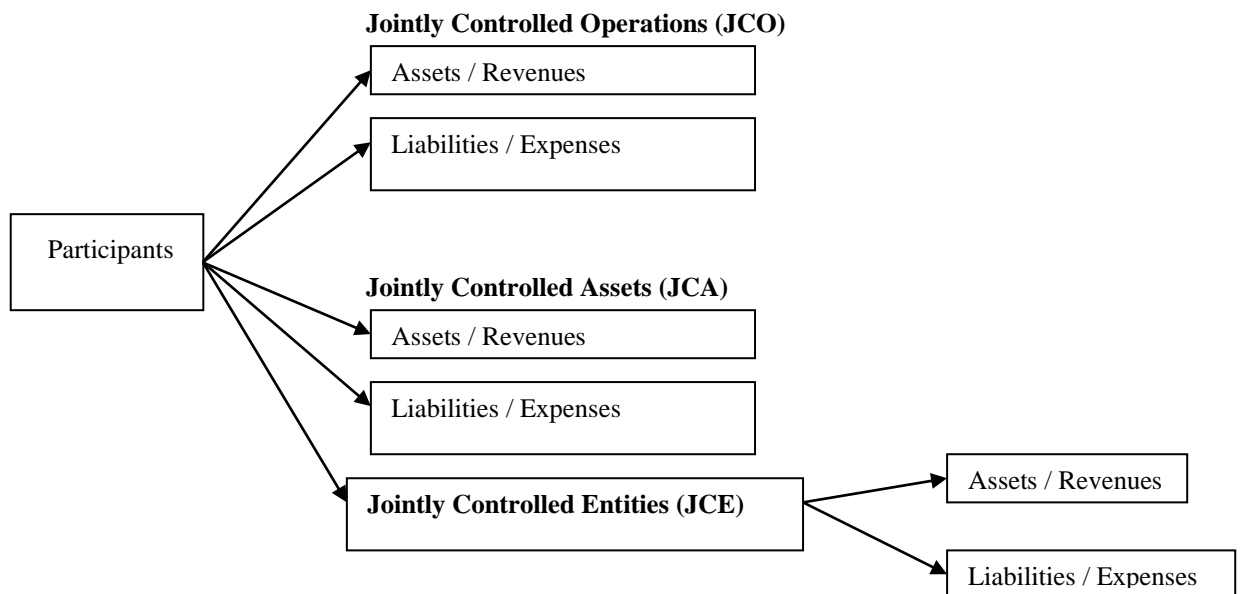
⁵ The term ‘undivided interest’ is used in the US accounting literature for referring to this situation. It is defined, for example, by the SOP 78-9 *Accounting for Investments in Real Estate Ventures* (‘an ownership arrangement in which two or more parties jointly own property, and title is held individually to the extent of each party’s interest’). The staff understands that this term refers mainly to the legal form of holding an interest in a share of an asset with other participants, usually in the form of a tenancy in common. For our purposes, legal form is not determinative, although relevant. Other legal forms, such as ownership through a limited liability company, might also imply that participants have in substance a direct interest in a share of underlying assets and liabilities (e.g.: through cross-contracts between the arrangement and participants). On the contrary some groups of assets held under the legal form of co-ownership or co-tenancy as an undivided interest or tenancy in common, with no legal entity set up, might have characteristics that lead to the conclusion that the participants have in substance an indirect interest in the net outcome of the operations carried out by that group of assets (see analysis of scenarios in Appendix B), even though no legal entity was set up. Only undivided interests under a joint arrangement subject to joint control are considered here. Other undivided interests not subject to joint control are not within the scope of IAS 31.

These restrictions might have an impact on each participant's rights and the value of the asset.

25. Suppose three entities acquire a shared interest in a piece of land. The primary purpose of the investment is capital appreciation. The land is maintained but no operating or rental income is derived during the period it is held. The sale or disposal of the land needs unanimous consent of three participants but each entity has the right to sell its interest in the asset to another party.
26. As a consequence, each entity has direct access to the benefits expected to be generated by the resource being a one-third interest in the value of the land. Each investor can realise its benefit by either by selling its one-third interest in the land or by waiting for the land to be sold by joint consent of all participants. That the land to be sold needs unanimous consent might affect the fair value of each one-third interest, but it does not affect the 'direct' nature of each participant's interest in that asset's residual value. In these cases each participant should recognise directly its share of the asset in its balance sheet. Although this is a right to a shared access it is a right to a share of an individual asset or resource. Therefore, it is recognised as a direct interest in a share of such individual asset rather than an interest in an 'entity' or group of resources carrying on an economic activity. A participant has, thus, a direct right to a share of the economic benefits expected to be generated directly by the individual resource under joint control. That right can be characterised in terms of an investment in such an asset and not an investment in a business, entity or group of assets intended to carry on an economic activity. Therefore, even though the single economic resource as a whole is under joint control, each participant has an asset based on the direct rights it has that should be recognised in its financial statements.
27. The third example is when participants have an interest in the economic benefits expected to be generated by a set or group of resources under joint control intending to carry out an economic activity. In such case the underlying resources are capable of generating expected economic benefits to the concerned participants only on an indirect way, in terms of the net result or output produced by that set of assets' economic activities. The set of assets is under joint control of all or some of participants in the arrangement, ie

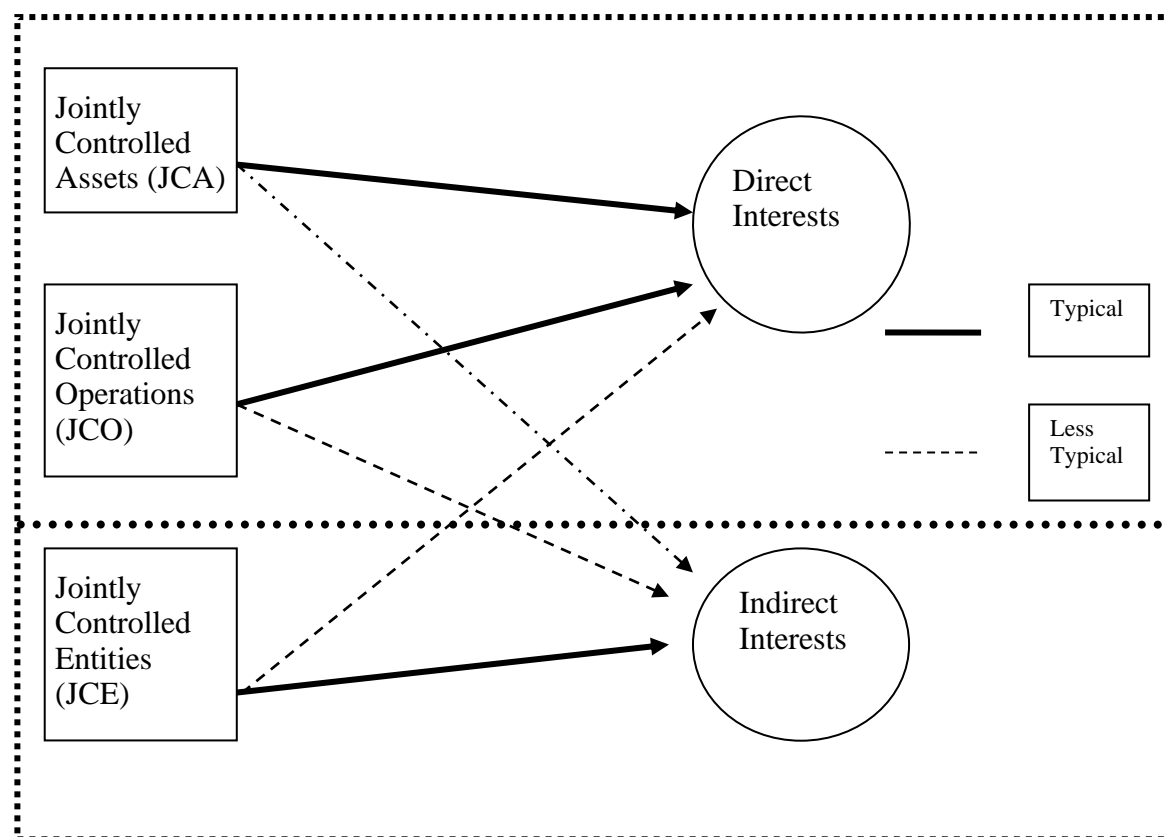
individual participants do not have control over individual assets and are not directly responsible for individual obligations of the arrangement. Participants, then, do not have direct access to the economic benefits being generated by individual resources. Each participant has only a direct access to, a direct interest in, the net result or output generated by the set of resources under joint control as a whole. It is not possible to identify direct rights held by any participant to individual resources within that set, or liabilities which participants are directly responsible for.

28. The purpose of a joint arrangement is to undertake an economic activity that is subject to joint control. Its nature is basically an operating agreement among participants. Depending on how economic activities are organised, which assets are under joint or unilateral control and which obligations participants or the arrangement are directly liable for, the different interests arisen from a joint arrangement might also be classified in one of the three following categories:
 - a. A direct interest in sharing in the revenues of the operations. Operations are developed separately by participants under a common agreed framework to distribute the common expected proceeds generated, whereby each participant has direct and unilateral rights to its own assets deployed and is directly responsible for liabilities it incurs.
 - b. A direct interest in the underlying assets and liabilities, or in a share of them.
 - c. An indirect interest in the net outcome or net output generated by a group of assets and liabilities of the arrangement itself.
29. The three types depicted above correspond to the classification currently set out in IAS 31 that can be illustrated as follows:



30. What needs to be clarified in IAS 31 is that these types may simultaneously coexist in a joint arrangement. Therefore, IAS 31 should ensure that the investor accounts for each of the different interests it has in an arrangement.

31. The relationship between the existing classification in IAS 31 and the staff proposal based on the interests participants may have as follows:



32. Participants should follow the following two-tier process in identifying the interests they have in a joint arrangement:

- (a) The first step is to identify the inventory of underlying assets, liabilities and operations developed under the ‘umbrella’ of the joint arrangement and to identify within that inventory ‘direct interests’, ie any direct right held by a participant to individual assets or any obligation for which a participant is directly responsible. Those identified assets and liabilities are recognised by the participants concerned.
- (b) Once those rights and obligations (‘direct interests’) have been recognised, any remaining assets and liabilities will be those to which participants do not have individual rights or privileged access to, or are not directly responsible for. Rather, they will only have a direct right or access to sharing in the common future benefits expected to be generated by the economic activities intended to be carried on by that

set of resources. The economic resource to which participants have rights is the net group of assets as a whole. This defines an indirect interest that should be accounted for using the equity method.

33. Assets or liabilities contributed by venturers to the joint venture, which they no longer have direct rights in or responsibility for, will have been derecognised by the venturers, in accordance with applicable standards.⁶
34. A group of assets and liabilities within a joint arrangement in which participants do not have direct rights or responsibilities but a right to share in its net result or outcome it generally means that those assets and liabilities are engaged in a common economic activity or operation.⁷ In that case the economic resource capable of generating economic benefits to the participant is not each and every individual asset and liability but the ‘group’ itself intending to carry on an economic activity of its own.⁸
35. Having identified the activities that form the venture itself a further step is to analyse whether the arrangement is subject to joint control, ie when the strategic financial and operating decisions require unanimous consent. If not, the arrangement is not a joint venture under the scope of IAS 31.

⁶ As examples, paragraphs 15-42 in IAS 39 *Financial Instruments: Recognition and Measurement* for derecognition of financial assets and liabilities; and paragraphs 67-72 in IAS 16 *Property, Plant and Equipment*. No asset can simultaneously be an asset of more than one entity. The entity having rights or other privileged access to an economic resource is the one that can typically exchange those rights or permit access, use the resource to which it has the rights to produce an output or reduce other expenditures, exact a price for other’s use of the rights or access, use them to settle liabilities, hold them, or distribute them to owners. (See paragraph 30 of Agenda Paper 5 *Conceptual Framework Elements 4*, Joint IASB/FASB April 2006 Meeting). In the assessment of the types of interests a participant has in the underlying group of assets and liabilities it should be analysed whether a participant has the ability to dispose separately of individual underlying assets and being discharged of individual underlying liabilities within the group or the participant may only dispose of their interest in the arrangement as a whole. If substantially all economic benefits expected to be generated by an asset of a participant dedicated to the arrangement were transferred and shall be recovered by the participant through its share in the outcome of the arrangement’s operations, that asset had been contributed to the arrangement.

⁷ When the access to a group of underlying assets and liabilities in a joint arrangement is direct, typically the arrangement merely holds those assets, which are not carrying a separate economic activity, at the availability of participants. On the contrary, when the group runs a separate economic activity participants generally have an interest in the net outcome of the economic activity intended to be carried out by that group of assets. Participants would not be involved in individual assets within the group but in its outcome. See also Appendix B.

⁸ As a first step, participants should recognise all rights and liabilities (direct interests) ‘originated’ from the joint arrangement initially. Consequently, in the remaining group of assets and liabilities subject to an indirect interest, participants do not have direct rights or obligations initially. However, direct rights and obligations of a ‘derived’ nature to such underlying group may arise subsequently from transactions between the joint arrangement itself and any of its participants. See also Appendix B.

Impact of legal structure for the substance of the arrangement

36. In April 2003 the Board decided to start a research project on joint venture arrangements. At that time the Board noted that the distinction between an interest in an investment and an interest in the underlying assets and liabilities should be based on the substance of an arrangement and not on whether a legal entity exists, although the legal structure might have significant implications for the substance of the arrangement.
37. The staff notes that in many cases legal form and economic substance are consistent with each other. However, in assessing the types of interests a participant has in a joint arrangement, when its legal form does not convey its economic substance the latter should prevail.
38. In the following paragraphs we will analyse three different legal structures and their implications for the substance of the arrangement:
- contractual arrangements;
 - partnerships; and
 - limited liability companies

Contractual arrangement (no legal entity is set up)

39. Irrespective of the legal structure, participants should look at the contract and the nature of the rights and obligations they have in the joint arrangement. In the absence of a legal entity participants typically have direct interests in the underlying assets and liabilities. However the contractual arrangements can be so constraining that they could have indirect interests. Some scenarios in Appendix B help illustrate this point.
40. A relevant issue is to assess whether the underlying liabilities should be recognised by participants or should be accounted for as part of the 'net' interest in the group of assets and liabilities. If a participant has a present obligation it should be recognised in its financial statements. And this should not be affected

by whether the liability stands alone or is within the boundaries of a joint contractual arrangement.⁹

41. In some cases assets contributed to the joint arrangement are financed directly by individual participants, sometimes with additional guarantees from the other participants. In other cases funds are borrowed in the arrangement's own account or on its behalf whereby the arrangement is responsible directly for the obligation and the assets of the arrangement are intended to provide directly the economic benefits for settling that obligation. Even if the latter case applies, participants would generally have an obligation to make good any eventual shortfall that would be recognised in accordance with the requirements in *IAS 37 Provisions, Contingent Liabilities and Contingent Assets*.
42. In making the assessment, all specific circumstances surrounding a case must be carefully considered. To be a liability of a participant the participant must have a present obligation to provide its economic resources to others. Only when it is the arrangement itself that must provide directly its economic resources for cancelling or settling the obligation is it appropriate to account for the 'net' interest. In addition, if the arrangement is not a limited liability arrangement, participants are likely to have an obligation to make good any shortfall if the assets of the arrangement are not enough to meet the arrangement's liabilities.

Partnerships

43. In a partnership, although deemed an entity in many jurisdictions, participants are generally liable for the arrangement's liabilities. IAS 31.24 includes partnerships as a possible example of a jointly controlled entity. In US GAAP, the AICPA Accounting Standards Executive Committee (AcSEC), in AIN-APB 18, concludes that many of the provisions of the opinion APB 18, including the application of the equity method, would be appropriate in accounting for an interest in a partnership or other unincorporated joint ventures.
44. The staff generally agrees with that conclusion. When the substance of the arrangement means that participants have an interest in the outcome of the

⁹ A joint arrangement may not justify that a present liability of a participant be 'offset' within its net interest in the arrangement.

arrangement's operations the equity method seems appropriate. Arguments used for mere contractual arrangements are equally applicable to partnerships.

Does the Board agree that in some circumstances as described in paragraphs 42-44 indirect interests in mere contractual arrangement or partnerships should be accounted for by the equity method?

45. For the characteristics of a partnership as a no-limited liability entity, participants should also generally consider the recognition of their obligations in accordance with IAS 37.

Legal incorporated entities such as a limited liability company by shares

46. The question is in what circumstances legal boundaries should be respected. The staff thinks that participants should look at the substance of the arrangement as in case of mere contractual arrangements and partnerships. Therefore, even though the arrangement is a legal incorporated entity, if in substance it entails participants having direct rights and obligations to the underlying assets and liabilities, those assets and liabilities should be recognised directly in the participants' financial statements.
47. Notwithstanding the above, if the entity has limited liability, then participants are not normally directly liable for the arrangement's liabilities unless existing cross contracts provide such direct liability for participants. Therefore, unless those cross contracts exist, participants have de facto an interest in the 'net' group of underlying assets and liabilities, as they are not directly responsible for the underlying entity's liabilities.¹⁰
48. Consider the following example. Two entities acquire a block of apartments to provide accommodation to their clients and overseas-based staff visiting the headquarters. For local tax and regulations they establish a limited company subject to joint control. The company does not have debt. In substance this is a direct and shared interest (a right of use) in the block of apartments. Participants have a direct access to its share of the common resource. Even if a participant cannot dispose of any of the apartments separately, but only of its

¹⁰ This does not prevent participants from firstly recognising any direct right they might have in the arrangement, such a right of use of particular assets.

interest in the company, the economic benefit are directly generated by the asset to each participant.

49. Now suppose that the company borrows funds. The question is what interest the participants have with the block as collateral with no recourse to participants. To generate enough funds to settle the borrowings the company leases out the apartments to third parties in periods there are vacancies. Now participants have an indirect interest in a ‘business’ arrangement. In addition they have retained a direct interest in the asset. These are the interests participants have in the arrangement:

- A direct right to using the apartments for their clients and staff.¹¹
- An indirect interest in the residual group of assets and liabilities:
 - the residual right of using and leasing the block apartments during periods there are vacancies; and
 - the outstanding liability that is intended to be settled with the revenues coming from the leases.

Interests in a business

50. At the March 2006 meeting the Board discussed whether the notion of a business was relevant to identify the nature of assets and liabilities that participants may have in a joint arrangement.

51. Some Board members thought it was not relevant and that if an interest in the net outcome of an arrangement exists it should be accounted for by the equity method, irrespective of whether it is a business. Other Board members thought that a concept of business is useful in identifying indirect interests.

¹¹ It might be argued that that direct interest should be recognised ‘net’ by offsetting its proportional part of the liability incurred. This does not seem correct. Only the company is liable for the whole borrowings. Such rights of use, whether they are held by participants or a third party, is the only direct interest they have and should be recognised gross. That right of use is not directly affected by the way the company (the joint arrangement) has financed its acquisition. However as participants’ rights of use are subject to an eventual lender’s execution of its lien on the asset, this will have an impact on its measurement. In addition, if those restrictions are significant they should be disclosed.

52. At that meeting Board members discussed different scenarios and were able to identify direct and indirect interests without explicit consideration to the concept of a business. However the staff thinks this was possible because Board members did already have a notion of business in mind, and it was implicitly used in their analysis.
53. The relevant question is not whether Board members explicitly or implicitly had in mind the concept of business in their discussions. The relevant questions are whether an indirect interest in a joint arrangement represents an interest in a business and whether an interest in a business under joint control is likely to be an interest in the net activities of the arrangement rather than a direct interest in the underlying single assets and liabilities of the arrangement. If that is not the case, the concept of business would not be useful in identifying indirect interests in a joint arrangement.
54. In a joint arrangement direct and indirect interests can coexist simultaneously. However, the staff thinks that the notion of a ‘business’ is helpful in identifying the nature of the interest a venturer has in a joint arrangement:
- An indirect interest assumes there is an interest in a jointly controlled business.
 - An interest in a business is likely to be an interest in the net activities of the arrangement rather than a direct interest in the underlying single assets and liabilities of the arrangement.
 - If an arrangement is not a business participants only have direct interests.

We explain this issue in more detail in Appendix A.

Does the Board agree?

55. One aspect that needs be discussed is whether the nature of the outcome of the arrangement’s operations is relevant in determining whether an indirect interest exists. In describing jointly controlled assets IAS 31.18 refers to venturers taking a share of the output from the assets. At the March 2006 meeting some Board members noted that they would be concerned if an arrangement was classified as a jointly controlled entity (indirect interest) in circumstances where

the output was a readily tradable commodity and the venturers indifferent to receiving cash or product. The staff was asked to ensure that the proposed revisions to IAS 31 address that possibility.

56. The staff proposes going further. According to its definition, the purpose of a business is providing a return to participants, lower costs or other economic benefits. Based on that, the staff thinks that an indirect interest of a participant in a jointly controlled business should be accounted for by the equity method. And this conclusion shall be applicable whether the output of such business is to provide a return in terms of a profit or loss, or whether it consists of a sharing-cost agreement whereby the output is, or not, traded on an active market.¹² That fact may affect the timing of income recognition but not the nature of the arrangement.¹³

Does the Board agree?

Disclosure

57. Some Board members expressed the opinion that the elimination of the option of proportionate consolidating jointly controlled entities might cause a loss of information useful to users of the financial statements of the investor.
58. IAS 31 requires entities to disclose in the notes the aggregate amounts of each of current assets, long-term assets, current liabilities, long-term liabilities, income and expenses related to their interests in jointly controlled entities. The staff thinks this is useful information for a proper understanding of the impact of an entity's interests in joint ventures in its financial statements. The staff also

¹² As an example several entities in the same industry set up a joint venture to produce some supply material to be used in their separate production processes to manufacture their final product. The supply produced under joint control is not traded on an active market. The joint venture is designed to distribute in kind this common output. If the group of resources is under joint control of all of participants and they have only an interest in the output (the supply material) expected to be produced by the arrangement's operations, participants have an indirect interest in the underlying group of assets and liabilities, even if the supply material is not actively tradable.

¹³ At present there are no specific measurement criteria for commodities traded on active markets. IAS 2 acknowledges in paragraph 3.a that for minerals and mineral products measurement at net realisable value is a well-established practice. However other measurement criteria, such a cost method, would also be possible. Therefore, the recognition of profit will depend on the measurement criteria applied. In addition, paragraphs 48-50 of IAS 31 shall be generally applied to transactions between a venturer and a joint venture.

notes that entities are currently allowed to account for their interests in jointly controlled entities by the equity method and many elect to do so.¹⁴

59. The staff thinks that imposing additional disclosure requirements on joint venturers cannot be justified without first undertaking a more comprehensive analysis of user needs. The staff believes that such an analysis would be better undertaken as part of the longer term project and therefore recommends that no additional disclosures be required as part of the short-term project.

Does the Board agree with that recommendation?

Convergence and Industry Practices

60. The staff has held some discussions with preparers and users about the likely impact of the proposed amendments on current practice in entities applying IFRSs as well as US GAAP in the oil and gas industry.
61. From those discussions the staff has the perception that the proposed amendments might change the current accounting treatment in a significant number of non-entity joint arrangements. The current practice is for them to be accounted for in accordance with what they call ‘proportionate consolidation’, which means direct recognition by participants of their share of assets and liabilities. However, some of those arrangements would entail some equity accounting based on staff proposals.
62. There is a risk that the proposals will not achieve the convergence with US practice that motivated the project. The staff will be seeking additional assistance from FASB staff to help assess that risk.

Flowchart: Recognition of direct and indirect interests in a joint arrangement

The following chart illustrated the evaluation of how a participant accounts for its direct and indirect interests in a joint arrangement.

¹⁴ [Footnote omitted from observer notes]

